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No.

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JAMES H. PUGH, JR. AND ALEXIS PUGH

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Respondent James D. Pugh, Jr. was a shareholder in an insolvent subchapter S corporation. During 1990, that corporation obtained a discharge of certain indebtedness. That discharge would have been treated as an item of "[i]ncome from discharge of indebtedness" (26 U.S.C. 61(a)(12)) except that, because the discharge occurred when the corporation was insolvent, the item is expressly "not include[d] * * * in gross income" under 26 U.S.C. 108(a)(1)(B). The question presented in this case is whether the amount thus expressly excluded from "income" is nonetheless to be treated as if it *were* an item of "income" which, under 26 U.S.C. 1366(a)(1)(A), flows through to respondent as the shareholder of the Subchapter S corporation, thereby increasing his basis in its stock under 26 U.S.C. 1367(a)(1)(A), and thereby allowing him to report a larger tax loss than he otherwise could have reported after the stock of the corporation became worthless.

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In the Supreme Court of the United States

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-17a) is reported at 213 F.3d 1324. The opinion of the Tax Court (App., *infra*, 18a-23a) is unofficially reported at 77 T.C.M. (CCH) 1367.

JURISDICTION

The judgment of the court of appeals was entered on June 5, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of Sections 108, 1366 and 1367 of the Internal Revenue Code, 26 U.S.C. 108, 1366, 1367, are set forth in the Appendix, *infra*, 24a-31a.

STATEMENT

1. a. In 1990, respondent James H. Pugh, Jr. owned 97 percent of the stock of Epoch Capital Corporation (ECC), a corporation that had elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code, 26 U.S.C. 1361-1379.[1] App., *infra*, 2a. As this Court explained in *Bufferd* v. *Commissioner*, 506 U.S. 523, 525 (1993), Subchapter S of the Code implements "a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships."

In 1990, while ECC was insolvent, its creditors forgave $661,357 of its debt. App., *infra*, 2a. This amount would have represented "[i]ncome from discharge of indebtedness" to the corporation (26 U.S.C. 61(a)(12)) except that, at the time of the discharge, the corporation was insolvent. Because the corporation was insolvent, this amount was expressly excluded from income under Section 108 of the Code, which specifies that "[g]ross income does not include any amount which * * * would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs when the taxpayer is insolvent." 26 U.S.C. 108(a)(1)(B).

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[1] Alexis Pugh is a party to this proceeding solely by virtue of having filed joint income tax returns with her husband for the years in suit. As a result, we refer to Mr. Pugh as respondent.

b. Although Section 108 of the Code specifies that discharge of indebtedness is *not* an item of income for an insolvent corporation, respondent argues that it should nonetheless be *treated* as if it were an item of income for purposes of Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax treatment of shareholders of a Subchapter S corporation. In particular, they specify that "items of income (including tax-exempt income), loss, deduction, or credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)). The basic concepts reflected in these provisions are: (i) that the income earned (or loss incurred) at the corporate level is treated as if it were earned (or lost) at the individual level; and (ii) that basis adjustments are made to avoid a double tax on those earnings or a double benefit from those losses.

c. ECC was liquidated in 1990, and its common stock became worthless during that year. App., *infra*, 2a. Section 165(a), (b) and (g) of the Code permit a loss deduction to be taken in the year that a security becomes worthless. 26 U.S.C. 165(a), (b) and (g). Under Section 1001(a) of the Code, the loss is computed as the excess of the shareholder's adjusted basis of the stock over the amount realized.

On January 1, 1990, respondent's basis in his ECC stock was $694,659. His distributive share of ECC's ordinary losses for 1990 was $199,857. App., *infra*, 2a

n.2. On his income tax return for 1990, respondent decreased his basis in ECC by the amount of these losses. *Ibid.* He also reported an ordinary loss of $100,000 on his ECC stock in 1990 under Section 1244 of the Code, which permits up to $100,000 that would ordinarily be treated as a capital loss on certain stock to be treated as an ordinary loss, and he decreased his basis in his ECC stock *pro tanto* under Section 1244(d)(1)(A). *Ibid.* Taking these adjustments into account, respondent's basis in his stock was $394,802 at the end of 1990. *Ibid.*

Respondent then treated his *pro rata* share of the debt forgiven to ECC ($612,245) as an item of "income" passing through to him under Section 1366(a)(1)(A) that increased his basis in the stock under Section 1367(a)(1)(A), even though, for the reasons described above, Section 108(a) of the Code expressly states that this is "*not*" an item of income. App., *infra*, 2a. Respondent therefore calculated the loss deductions attributable to the worthlessness of the stock by using an adjusted basis that was augmented by his share of the amount of the forgiven debt. *Ibid.*

Upon audit, the Commissioner of Internal Revenue determined that respondent was not entitled to increase his stock basis by the discharge of indebtedness that was "not" an item of income under Section 108 of the Code. The Commissioner therefore disallowed the portion of the deductions claimed by respondent that was inflated by the upward basis adjustment and asserted income tax deficiencies against respondent. App., *infra*, 3a.

2. Respondent filed a petition in Tax Court to contest the deficiencies. The Tax Court held that the discharge of the indebtedness of the Subchapter S corporation did not increase respondent's basis in the stock of

that corporation. App., *infra*, 18a-23a. The court followed its reviewed decision in *Nelson* v. *Commissioner*, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 1999), in which the Tax Court unanimously concluded that a discharged debt that is excluded from a Subchapter S corporation's gross income because of its insolvency does not constitute an item of "income" that would increase a shareholder's stock basis in the corporation. App., *infra*, 21a.

3. The Eleventh Circuit reversed. App., *infra*, 1a-17a. The court "acknowledge[d] the justice of the Commissioner's position" but concluded that the plain meaning of Sections 1366(a)(1)(A) and 1367(a)(1)(A) of the Code "clearly requires" that an amount excluded from an insolvent Subchapter S corporation's gross income under Section 108 passes through the corporation to its shareholder and increases his basis in the stock of the corporation. App., *infra*, 16a. The court noted that in *Gitlitz* v. *Commissioner*, 182 F.3d 1143 (1999), cert. granted, 120 S. Ct. 1830 (2000), the Tenth Circuit held that the amount of the discharge of indebtedness of an insolvent Subchapter S corporation does not pass through to its shareholders as an item of "income" under Section 1366 or increase their basis in the stock of the corporation under Section 1367. App., *infra*, 9a-11a. The Eleventh Circuit distinguished *Gitlitz* on the ground that the taxpayers in that case were seeking to use the discharge of the corporation's indebtedness to obtain upward basis adjustments that would allow them to deduct corporate losses that were otherwise nondeductible under Section 1366(d)(1) of the Code. *Id.* at 10a.[2] The court nonetheless acknowledged that the

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[2] Section 1366(d)(1) provides that the aggregate amount of corporate losses and deductions that may be taken into account by

Tenth Circuit in *Gitlitz* had described examples in its opinion in that case that indicated that an amount excluded from an S corporation's gross income does not pass through to its shareholders even when the shareholders are not seeking deductions for otherwise nondeductible corporate losses. *Id.* at 11a n.10 (citing *Gitlitz* v. *Commissioner*, 182 F.3d at 1150 n.6). The Eleventh Circuit also noted that, in a companion case to *Gitlitz*, the Tenth Circuit affirmed a Tax Court decision that denied an upward basis adjustment from the discharge of indebtedness of an insolvent Subchapter S corporation for a shareholder who did not have losses that were nondeductible under Section 1366(d)(1). App., *infra*, 11a n.10 (citing *Nelson* v. *Commissioner*, 182 F.3d 1152 (10th Cir. 1999)).

REASONS FOR GRANTING THE PETITION

This case presents the same question that is presented in *Gitlitz* v. *Commissioner*, cert. granted, No. 99-1295 (May 1, 2000), which is set for argument in this Court on October 2, 2000. The petition in this case should therefore be held and disposed of as appropriate in light of the Court's disposition of the *Gitlitz* case.

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a shareholder of an S corporation (under Section 1366(a)(1)(A)) shall not exceed the shareholder's adjusted basis in the stock of the corporation and the shareholder's adjusted basis in any debt owed to him by the corporation. Corporate losses that are not deductible under Section 1366(d)(1) are carried forward into future years (and are therefore referred to as "suspended" losses), but may be deducted in future years only if the shareholder acquires additional basis in the corporation. 26 U.S.C. 1366(d)(2).

CONCLUSION

The petition for a writ of certiorari should be held and disposed of as appropriate in light of the Court's disposition of *Gitlitz* v. *Commissioner*, No. 99-1295.

Respectfully submitted.

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AUGUST 2000

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 99-12646
T.C. Docket No. 27237-96

JAMES H. PUGH, JR. AND ALEXIS PUGH, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[Filed: June 5, 2000]

Before: CARNES, BARKETT and WILSON, Circuit Judges.

WILSON, Circuit Judge:

This case features a taxpayer who seeks to take personal tax advantage from his S corporation's insolvency. Put simply, the taxpayer owned shares in an S corporation. The corporation owed money, was forgiven the debt, and then liquidated. The taxpayer sought to have the cancellation-of-debt (COD) income flow through to him and increase his basis in his S corporation stock. Then the taxpayer claimed a tax deduction for a capital loss based on the increased basis. The Tax Court ruled that the COD income belonged only to the S corporation, did not flow through to the taxpayer, and did not increase his basis. We hold that although the tax treatment urged by the taxpayer seems contrary to the Code's spirit, it is dictated by the

Code's plain language. We therefore reverse the decision of the Tax Court.

BACKGROUND

Appellant James Pugh ("Pugh")[1] owned shares in Epoch Capital Corporation ("Epoch"), an S corporation that fell on hard times in 1990. Being insolvent, Epoch was forgiven $661,357 in debt, realized the same amount in cancellation-of-debt (COD) income, liquidated, and filed articles of dissolution. At the time of liquidation, Pugh owned 97% of Epoch's then-worthless stock. He did not receive any distribution from Epoch when it liquidated.

On its 1990 tax return, Epoch excluded the COD income from its gross income. In preparing his personal tax returns, Pugh treated Epoch's COD income by applying the "pass-through" principles and basis adjustment provisions normally applicable to subchapter S corporate shareholders. Pugh adjusted his basis upward by $612,245, his share of Epoch's COD income. By increasing his basis, Pugh sought to take advantage of the losses resulting from the precipitous decline in the value of his stock. Pugh claimed a capital loss for the Epoch stock on his 1990 return and a carry-forward loss on his 1991 return.[2] Pugh had no other losses carrying forward from previous years.

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[1] Mr. Pugh's wife Alexis is party to the appeal solely because she filed joint returns with her husband for the years at issue.

[2] On Pugh's personal return, he reported his distributive share of Epoch's ordinary losses ($199,857) and an additional loss of $100,000. Taking only these loss adjustments into account, Pugh's basis was $394,802 at the end of 1990.

The Commissioner determined that Pugh was not entitled to increase his basis by the amount of the COD income, and asserted deficiencies against Pugh. Pugh contested the deficiencies by filing a petition in the tax court. The tax court, relying on *Nelson v. Commissioner*, 110 T.C. 114, 1998 WL 66131 (1998),[3] ruled that "COD income realized and excluded from gross income under section 108(a) does not pass through to shareholders of an S corporation as an item of income in accordance with section 1366(a)(1) so as to enable an S corporation shareholder to increase the basis of his stock under section 1367(a)(1)." This appeal followed.

DISCUSSION

We have jurisdiction to review the decisions of the Tax Court "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." 26 U.S.C. § 7482(a)(1). The Tax Court's statutory interpretation receives *de novo* review. *See Estate of Wallace v. Commissioner*, 965 F.2d 1038, 1044 (11th Cir. 1992) (quoting *Young v. Commissioner*, 926 F.2d 1083, 1089 (11th Cir. 1991)).

At issue in this appeal is the amount of loss Pugh can deduct as a capital loss on his tax return. Pugh's capital loss is determined with reference to his adjusted basis in his Epoch stock;[4] Pugh and the Commissioner dis-

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[3] The Tenth Circuit affirmed Nelson on the rationale of its opinion in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), *cert. granted*, — U.S. ——, 120 S.Ct. 1830, 146 L.Ed.2d 774, 68 U.S.L.W. 3497 (May 1, 2000) (No. 99-1295). *See Nelson v. Commissioner*, 182 F.3d 1152 (10th Cir. 1999).

[4] *See* 26 U.S.C. §§ 165(b), 1001(a), 1011.

agree on whether Pugh's basis could reflect his pro rata share of Epoch's cancellation-of-debt (COD) income.

This Circuit has not addressed the issue of whether COD income realized and excluded from gross income under 26 U.S.C. § 108(a) passes through to shareholders of an S corporation as an item of income under 26 U.S.C. § 1367(a)(1), and whether S corporation shareholders can increase their individual stock basis to reflect the corporation's COD income. The answer involves the interplay between the way the Code treats COD income and the way the Code treats the tax liability of S corporation shareholders.[5]

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[5] The proper treatment of an S corporation's COD income has been the subject of much discussion by the courts and commentators. The Supreme Court has granted certiorari review in one case, with two petitions for certiorari review pending as of the date of this opinion. *See Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir.1999), *cert. granted*, — U.S. ——, 120 S.Ct. 1830, 146 L.Ed.2d 774, 68 U.S.L.W. 3497 (May 1, 2000) (No. 99-1295); *United States v. Farley*, 202 F.3d 198 (3d Cir.), *petition for cert. filed*, 68 U.S.L.W. 3670 (U.S. Apr. 17, 2000) (No. 99-1675); *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir.), *petition for cert. filed*, (U.S. Apr. 17, 2000) (No. 99-1693); *see also Nelson v. Commissioner*, 182 F.3d 1152 (10th Cir.1999); *Hogue v. United States*, 85 A.F.T.R.2d 2000-426 (D.Ore., 2000) (No. 99-302-K1, Jan. 3, 2000). For commentary, *see, e.g.*, Richard Gore, *Quandary for S Corp. COD Income Pass-Throughs*, 56 Tax'n for Acct. 157 (1996) (discussing dilemma that accountants face in advising their clients on COD treatment); Richard M. Lipton, *Different Courts Adopt Different Approaches to the Impact of COD Income on S Corps.*, 92 J. Tax'n 207 (2000); Richard M. Lipton, *The Impact of Excluded COD Income on S Shareholders-The 10th Cir. Gets Lost in Gitlitz*, 91 J. Tax'n 197 (1999); Richard M. Lipton, *Tax Court Rejects S Corp. Basis Step-Up for COD Income in Nelson*, 88 J. Tax'n 272 (1998); James D. Lockhart & James E. Duffy, *Tax Court Rules in Nelson that S Corp. Excluded COD Income Does Not Increase*

Our analysis begins with the language of the Code itself. *See Griffith v. United States* (In re *Griffith*), 206 F.3d 1389 (11th Cir.2000) (en banc). "[I]f the language of the statute is plain, then our interpretative function ceases and we should 'enforce [the Code] according to its terms.'" *Id.* at 1393 (quoting *Caminetti v. United States*, 242 U.S. 470, 37 S.Ct. 192, 61 L.Ed. 442 (1917)). Because the Code clearly provides that all S corporation income passes through to the corporation's shareholders and increases their basis by the amount of the pass-through, we must reverse the tax court.

1) *Pass-through income.*

S corporations allow many small business owners to enjoy the limited liability of the corporate structure without, for the most part, being subject to taxation at the corporate level. *See* 26 U.S.C. § 1363(a); *Beard v. United States*, 992 F.2d 1516, 1518 (11th Cir. 1993). Congress implemented this mechanism by providing that the tax repercussions of an S corporation's income and losses pass directly through to its shareholders. *See* 26 U.S.C. § 1366; *Beard*, 992 F.2d at 1518 (noting that S corporation "generally does not pay income taxes as an entity").

Accordingly, shareholders of S corporations determine their tax liability by taking into account their pro rata share of the S corporation's "items of income (including tax-exempt income), loss, deduction, or credit

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Shareholder Basis, 25 Wm. Mitchell L.Rev. 287 (1999); Stephen R. Looney, *S Corp. Prop. Regs.—No Surprises, but Two Potentially Controversial Provisions*, 90 J. Tax'n 69 (1999) (discussing controversy surrounding IRS's position on treatment of COD income).

the separate treatment of which could affect the liability for tax of any shareholder, and [ ] nonseparately computed income or loss." 26 U.S.C. § 1366(a)(1). The character of these pass-through items "shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." 26 U.S.C. § 1366(b). Therefore, to determine whether Epoch's COD income passes through to Pugh, we must determine whether it is the type of income suitable for pass-through treatment.

Nature of Cancellation-of-Debt Income.

Forgiveness of debt is income because it frees up assets that the taxpayer previously had to dedicate toward repaying its obligations. *See, e.g., United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 582, 111 S.Ct. 1512, 113 L.Ed.2d 608 (1991); *United States v. Kirby Lumber Co.*, 284 U.S. 1, 52 S.Ct. 4, 76 L.Ed. 131 (1931). Normally, COD income is included in gross income and would thus pass through to an S corporation's shareholders. *See* 26 U.S.C. §§ 61(a)(12), 1366(a).

But there is an exception for insolvent debtors. For them forgiveness of debt means little, for even after forgiveness the debtors still owe more than they have. Because insolvents cannot enjoy the freed-up assets, courts have ruled that they need not include the COD amounts in gross income. *See, e.g., Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934) (noting that cancellation of insolvent's debt "did not have the effect of making the respondent's assets greater than they were before that transaction occurred. . . . A transaction whereby nothing of exchangeable value comes to or is received

by a taxpayer does not give rise to or create taxable income."). Congress codified this exception in 26 U.S.C. § 108, which excludes COD income from gross income if the taxpayer is insolvent. *See* 26 U.S.C. § 108(a)(1)(B).[6]

In granting the exemption, Congress exacted a price. Taxpayers who exclude COD income must offset the exclusion against favorable tax attributes such as net operating losses and capital loss carryovers. *See* 26 U.S.C. § 108(b)(1), (b)(2)(A), (b)(2)(D). These reductions occur after determining tax liability "for the taxable year of the discharge." 26 U.S.C. §108(b)(4)(A). Further, for S corporations the reductions apply "at the corporate level." 26 U.S.C. § 108(d)(7)(A). Because neither Pugh nor Epoch had unused net operating losses or carryover losses, the offset does not apply directly to this case. However, the Commissioner argues that these provisions show Congress's intent for COD income to stop at the corporate entity and not pass through to S corporation shareholders. To address this argument, we must consider how § 108 applies to S corporations in particular.

Effect on S Corporation Pass-Through.

In the case of S corporations, § 108's exclusion (and reduction of tax attributes) "shall be applied at the corporate level." 26 U.S.C. § 108(d)(7)(A). Further, "any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1)"—that is, losses normally belonging to the shareholders themselves—"shall be treated as a net

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[6] " 'Insolvent' means the excess of liabilities over the fair market value of assets." 26 U.S.C. § 108(d)(3). No one disputes that Epoch was insolvent.

operating loss for such taxable year." 26 U.S.C. § 108(d)(7)(B).

This language, standing alone, does not explicitly trump the usual S corporation pass-through rules. *All* income that flows through an S corporation begins "at the corporate level." Nothing in § 108 expressly marks COD income for special bottlenecking—that is, that COD income "at the corporate level" means "at the corporate level and no further." To see whether COD income passes through to S corporation shareholders, we must inquire whether COD income is an "item of income . . . the separate treatment of which could affect the liability for tax of any shareholder." 26 U.S.C. § 1366(a)(1).[7]

The Commissioner's position is that COD income does not pass through under § 1366(a)(1) because it is not an item of income that can pass to shareholders. The Commissioner argues that § 108 is merely a tax deferment provision, and that COD income not used to reduce corporate tax attributes becomes a nullity. The Commissioner relies on legislative history to show Congress's intent that once a taxpayer reduces its tax attributes, "Any further remaining debt discharge . . . does not result in income or have other tax consequences." S.Rep. No. 96-1035, at 2 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, at 7018.

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[7] S corporation shareholders also include in their income "nonseparately computed income or loss." 26 U.S.C. § 1366(a)(1)(B). This provision does not apply here because "nonseparately computed income" means gross income (less the corporation's deductions), *see* 26 U.S.C. § 1366(a)(2), and Epoch's COD income was excluded from gross income. *See* 26 U.S.C. § 108(a)(1).

If the S corporation cannot use the COD income to reduce attributes, the Commissioner argues, it never flows through to the S corporation's shareholders. This position was expressed by Judge Beghe in his concurrence in *Nelson*, 110 T.C. at 131-132 (Beghe, J. concurring) (opining that an insolvent S corporation's COD income could not pass through to a solvent shareholder and the "equivalence rule of section 1366(b)" could not apply).

But as the Third Circuit pointed out, "This statement, made without elaboration by Judge Beghe, is simply incorrect." *United States v. Farley*, 202 F.3d 198, 208 (3d Cir.), *petition for cert. filed*, 68 U.S.L.W. 3670 (U.S. Apr. 17, 2000) (No. 99-1675). The Commissioner's argument ignores the clear language of § 1366, which provides that all items of corporate income that could affect shareholders' tax liability pass through to them as if "incurred in the same manner as incurred by the corporation." *See* 26 U.S.C. § 1366(a)(1)(A), (b). Accordingly, the Commissioner's argument has been rejected by every circuit that has considered it. *See Farley*, 202 F.3d at 205 n. 4 ("the language of section 108(b)(4)(A) is clear and unambiguous . . . COD income excluded from gross income under section 108 passes through to the S corporation's shareholders"); *Witzel v. Commissioner*, 200 F.3d 496, 498 (7th Cir.) (noting that COD income flows through to S corporation shareholder), *petition for cert. filed* (U.S. Apr. 17, 2000) (No. 99-1693); *Gitlitz v. Commissioner*, 182 F.3d 1143, 1148 (10th Cir. 1999) ("the items must pass through to shareholders unless they are absorbed by tax attribute reductions"), *cert. granted*, — U.S. ——, 120 S.Ct. 1830, 146 L.Ed.2d 774, 68 U.S.L.W. 3497 (May 1, 2000) (No. 99-1295).

One important difference, however, separates Pugh from the taxpayers in the above cases. Gitlitz, Witzel and Farley all personally carried suspended losses into the years their corporations received COD income. *See* § 1366(d)(1) and (2) (requiring that S corporation shareholders carry over losses that exceed their adjusted basis in their S corporation stock). A suspended loss "disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year." 26 U.S.C. § 108(d)(7)(B). Therefore, Gitlitz, Witzel and Farley—either in the year of discharge or in years thereafter—potentially faced direct changes in their tax liability relating to their suspended losses.[8] By con-

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[8] *See Gitlitz*, 182 F.3d at 1150 n. 6 (setting out illustrative examples, including Examples 3 and 4, where taxpayer's suspended losses are characterized as part of the S corporation's net operating losses); *Witzel*, 200 F.3d at 498 (holding that shareholder's suspended losses are "offset at the corporate level by the amount of his corporation's COD income"); Gore, *supra* note 5 ("Because Section 108 may reduce a shareholder's suspended losses, the COD income must pass through to the shareholders."). *Contra Farley*, 202 F.3d at 205 (COD income "shall be applied to reduce the tax attributes of the corporation, rather than the individual shareholder"). The *Farley* court further noted that even if § 108(d)(7)(B) required a shareholder's suspended losses to be considered as net operating losses, "nowhere does section 108(d)(7)(B) indicate that S corporation [COD] income should reduce such net operating losses 'for the taxable year of discharge.'" *Id.* at 207 (quoting 26 U.S.C. § 108(d)(7)(B)). *See also* Lockhart & Duffy, *supra* n. 5, at 299 ("Section 108(d)(7) does not operate to convert shareholder suspended losses into S corporation NOLs. . . . Section 108(d)(7)(B) provides the mechanism by which the shareholder attribute (suspended losses) will be subject to the existing corporate attribute reduction regime under 108(b)(2)(A)."). Because Pugh possessed no suspended losses, we

trast, when Pugh's S corporation realized its COD income, Pugh had no suspended losses. Even if Pugh treated Epoch's COD income as his own,[9] it would not have altered his tax liability directly because he possessed no suspended losses to be affected. Therefore, Epoch's COD income does not at first blush fall within the category of items of income to be passed through to Pugh. *See* 26 U.S.C. § 1366(a)(1)(A) (allowing for pass- through of "items of income . . . which could affect the liability for tax of any shareholder"). [10]

Of course, the COD income ultimately affects Pugh's tax liability by flowing through under § 1366 and thus increasing Pugh's basis pursuant to § 1367(a)(1)(A). In addition, § 1366(a)(1) does allow one type of income to pass through that might not affect taxpayers' liability initially, namely "tax-exempt income." 26 U.S.C. § 1366(a)(1)(A). Congress provided for pass-through of tax-exempt income to preserve its nature: if tax-exempt income did not flow through under § 1366 and increase shareholders' bases, they would have to pay tax when they sold their stock. *See* 11 Jacob Mertens, *Law of Fed. Income Taxation* § 41B:154 ("A share-

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need not today reach the issue of how to treat an S corporation shareholder's suspended losses.

[9] *See* 26 U.S.C. § 1366(b) (pass-through income is characterized "as if such item were realized directly from the source from which realized by the corporation").

[10] The Tenth Circuit appears to consider that COD income cannot pass through to shareholders without suspended losses, as shown by its affirmance in *Nelson*, where the shareholder had no suspended losses, and as shown in one of the examples the court used to illustrate its reasoning in *Gitlitz*. *See Gitlitz*, 182 F.3d at 1150 n. 6 (Example 1).

holder's increase in basis for tax-exempt income allows the shareholder to avoid recognition of gain as a result of receiving such income (reduced by any distributions) upon the sale of such stock.").

The Commissioner argues that COD income is not "truly" tax-exempt because, unlike other sources of tax-exempt income, COD income is never distributed to shareholders with a corresponding reduction in basis.[11] This distinction is not supported by the plain language of the Code, which simply designates "tax-exempt" income without any limitation on whether or not the income eventually becomes distributed to shareholders. *See* 26 U.S.C. § 1366(a)(1)(A).

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[11] In *Farley* and *Witzel*, the Commissioner argued that § 108 income was not tax-exempt but only tax-deferred, because it would eventually be offset against tax attributes. *See Farley*, 202 F.3d at 209-10 (rejecting argument); *Witzel*, 200 F.3d at 498 (rejecting argument and similar dicta of *United States v. Centennial Sav. Bank*, 499 U.S. 573, 580, 111 S.Ct. 1512, 113 L.Ed.2d 608 (1991) (although the Supreme Court described § 108 income as tax-deferred, it did so in passing while interpreting a now-deleted provision of § 108)).

The IRS does not treat § 108 income as tax-exempt in its final regulations. *See* 26 C.F.R. § 1.1366-1(a)(2)(viii):

> [T]ax-exempt income is income that is permanently excludible from gross income in all circumstances. . . . For example, income that is excludible in gross income under section 101 (certain death benefits) or section 103 (interest on state and local bonds) is tax-exempt income, while income that is excludible from gross income under section 108 . . . is not tax-exempt income.

Id. The regulations became effective August 18, 1998 (*see* 64 FR 245) and do not apply to this case; accordingly, we do not address their validity.

The COD exemption is located in the part of the Code titled "Items Specifically Excluded from Gross Income." This section includes various types of tax-exempt income, such as tax-exempt bond income and life insurance proceeds. *See* 26 U.S.C. §§ 101-136. The language in § 108 excluding COD income from gross income is virtually identical to that in other sections. *Compare* 26 U.S.C. § 108(a)(1) (excluding COD income from gross income) *with* 26 U.S.C. § 101(a)(1) (excluding life insurance proceeds from gross income).[12] Nothing in the Code distinguishes COD income from its cohort as being not "really" tax-exempt.

This is particularly true here, where neither Epoch nor Pugh possessed tax attributes to offset the tax-exempt status of Epoch's COD income. As Judge Posner noted, absent suspended losses, COD income flows through to S corporation shareholders "tax exempt in the fullest sense." *Witzel*, 200 F.3d at 498. *See also Farley*, 202 F.3d at 210 (acknowledging Commissioner's concession that "discharge of indebtedness income is sometimes tax-exempt"); *Gitlitz*, 182 F.3d at 1147 n. 3 ("If a taxpayer's attributes are insufficient to absorb all of his cancellation of indebtedness income, § 108 effectively provides a permanent exception from taxation on that income."). We join these circuits in ruling that an S corporation's COD income passes through pro rata to its shareholders under § 1366(a)(1),[13] and add that this is so even when the

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[12] This point is made by Lockhart & Duffy, *supra* n. 5, at 304 ("in light of the identical statutory language of Sections 101 and 108, it is unclear why" COD income should be treated differently than insurance proceeds).

[13] The circuits are split on whether the tax attribute reduction occurs at the corporate level before the pass-through, *e.g.*, *Witzel*,

shareholder possesses no suspended losses to offset the COD income.

2) *Increase in Basis.*

The real sticking point, of course, is not whether Pugh can include Epoch's COD income as an item of income, but whether he can take a personal capital loss deduction boosted by his share of that same COD income. Pugh's loss deduction is determined with reference to his basis;[14] the question thus is whether Pugh can increase his basis to reflect the passed-through COD income.

In general, S corporation shareholders' initial basis corresponds to their cost of the stock plus capital contributions. *See* 26 U.S.C. §§ 1011-1016; 11 Jacob Mertens, *Law of Fed. Income Taxation* § 41B:147. Shareholders' basis in their S corporation stock increases by "the items of income described in subparagraph (A) of section 1366(a)(1)" and decreases by "the items of loss and deduction described in subparagraph (A) of section 1366(a)(1)." 26 U.S.C. § 1367(a). These "items of income" include not only gross income but also other types of income, including tax-exempt income. *See* 26 U.S.C. § 1366(a)(1); *Farley*, 202 F.3d at 206; *Witzel*, 200 F.3d at 498; 15 Collier on Bankruptcy ¶ TX6.03[5][c] ("If discharge income is excluded at the S corporation level under I.R.C. Section 108(a), the shareholders should be entitled to increase the basis of

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200 F.3d 496; *Gitlitz*, 182 F.3d 1143; or whether the reduction occurs after the pass-through of COD income; *see Farley*, 202 F.3d 198. Because neither Pugh nor Epoch possessed tax attributes to reduce, we need not reach the issue.

[14] *See* 26 U.S.C. §§ 165(b), 1001, 1011.

their stock and debt under I.R.C. Section 1367 for their ratable share of excluded income. Under a plain reading of the statutory language, a step-up in basis is allowed for all income, including tax-exempt income.") Therefore, § 1367 requires that Pugh's basis be increased by the amount of COD income that passed through to him from Epoch.

We recognize that this statutory scheme can lead to the result that shareholders actually benefit from their S corporations' insolvency. Not only do they avoid taxation on the corporation's COD income, but also they may receive capital loss deductions based on their share of the COD income. This jars with the general rule that basis should increase only to the extent of a taxpayer's actual "economic outlay." *See, e.g., Sleiman v. Commissioner*, 187 F.3d 1352, 1357 (11th Cir.1999) (quoting *Selfe v. United States*, 778 F.2d 769, 772 (11th Cir.1985)); *see also Gitlitz*, 182 F.3d at 1151.

Normally, basis increases to the extent the taxpayer reports income from the S corporation; otherwise, the taxpayer would pay double tax upon receiving a distribution or selling the shares. *See* 26 U.S.C. § 1367(a)(1)(A). But if the S corporation receives tax-exempt income that passes through to the shareholder, the shareholder's basis is increased to preserve the tax-exempt nature of the income. *See id.*, 26 U.S.C. § 1366(a)(1)(A). This is so even without an "economic outlay" by the shareholder. *See, e.g., Farley*, 202 F.3d at 207 n. 5 (noting that "numerous exceptions" to economic outlay rule exist, including treatment of COD income as well as life insurance benefits and tax-exempt bond income: "section 108 cannot be distinguished from sections 101 and 103 on the basis of economic outlay

considerations"); Lockhart & Duffy, *supra* n. 5, at 304 (noting that in light of identical statutory language, "it is unclear why the absence of an economic outlay results in excluded COD income being treated differently"); *cf. CSI Hyrdostatic Testers, Inc. v. Commissioner*, 62 F.3d 136 (5th Cir. 1995) (adopting Tax Court's rejection of argument that S corporation's parent should not receive benefit of subsidiary's COD income because parent had not "paid for" it (*see* 103 T.C. 398, 409, 1994 WL 466342 (U.S. Tax Court 1994))); *but see Gitlitz*, 182 F.3d at 1151 (distinguishing COD income because taxpayer made no initial economic outlay).

The Commissioner argues that §§ 108, 1366 and 1367 should be read together to prevent Pugh from enjoying twice the tax-exempt status of COD income. We must acknowledge the justice of the Commissioner's position, for unlike other sources of tax-exempt income, COD income becomes tax-exempt merely from the infelicitous combination of corporate insolvency and a lack of tax attributes to offset the COD income. But we cannot ignore the language of the statute, which clearly requires that all items of income included in § 1366 must be used to increase the shareholder's basis under § 1367. "The relevant question is not whether, as an abstract matter, the rule advocated by petitioners accords with good policy. . . . Courts are not authorized to rewrite a statute because they might deem its effects susceptible of improvement." *Badaracco v. Commissioner*, 464 U.S. 386, 398, 104 S.Ct. 756, 78 L.Ed.2d 549 (1984). While we agree with the Third Circuit that Congress may not have intended the result

dictated by the statute,[15] we must leave rewriting the Code to Congress.

CONCLUSION

Pugh is entitled to increase the basis in his Epoch stock by his pro rata share in the corporation's COD income for 1990. This case is REVERSED and REMANDED for proceedings in light of this opinion

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[15] *See Farley*, 202 F.3d at 212 n. 10.

APPENDIX B

UNITED STATES TAX COURT

No. 27237-96
T.C. Memo. 1999-38

JAMES H. PUGH, JR., AND ALEXIS C. PUGH,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[Filed: Feb. 8, 1999]

MEMORANDUM OPINION

COHEN, Chief J.:

Respondent determined deficiencies in petitioners' Federal income tax of $83,181 and $76,723 and penalties under section 6662(c) of $16,636 and $15,432 for the taxable years 1990 and 1991, respectively. After concessions, the issues for decision are:

(1) Whether petitioner James H. Pugh, Jr. (petitioner), may increase his basis in stock of an S corporation by the amount of discharge of indebtedness income (also referred to as cancellation of debt (COD) income) excluded from gross income under section 108(a), and (2) whether petitioners are liable for the accuracy-related penalties for negligence or disregard of rules or regulations for 1990 and 1991. Respondent has conceded that portion of the penalty for each year that relates to the first issue to be decided in this case.

Unless otherwise indicated, all section references are to the Internal Revenue Code as in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

This case was submitted fully stipulated pursuant to Rule 122. The stipulated facts are incorporated herein by this reference. Petitioners resided in Orlando, Florida, at the time they filed the petition.

Background

The first issue in this case concerns petitioner's interest in Epoch Capital Corporation (ECC). ECC was incorporated in the State of Florida on December 10, 1987. ECC had properly elected to be treated as an S corporation pursuant to section 1362 prior to 1990, and such election was effective for ECC's taxable year ended December 31, 1990.

ECC realized COD income during 1990 in the amount of $661,357. ECC was liquidated in 1990. Articles of Dissolution were filed with the State of Florida on December 18, 1990. Petitioner did not receive any distributions from ECC upon liquidation. Petitioner's ECC common stock became worthless during 1990.

In completing its 1990 Form 1120S, U.S. Income Tax Return for an S Corporation, ECC properly excluded the COD income from its income pursuant to section 108. On petitioner's Schedule K-1 (Form 1120S), Shareholder's Share of Income, Credits, Deductions, Etc., ECC separately stated the COD income and reported petitioner's pro rata share in the amount of $612,245. Petitioner increased his basis in his ECC stock in 1990 by the $612,245. Petitioner's basis in his ECC stock on

December 31, 1990, taking into account all adjustments other than that for ECC's COD income, was $394,802. On petitioners' 1990 Federal income tax return, they reported a capital loss with respect to the ECC stock commensurate with petitioner's reported basis in the stock. On their 1991 return, petitioners carried forward and reported capital losses from 1990. Coopers & Lybrand, a certified public accounting firm, prepared petitioners' tax returns for 1990 and 1991 and ECC's return for 1990.

Respondent disallowed the inclusion of the COD income in petitioner's basis in his ECC stock and reduced Mr. Pugh's loss accordingly. Respondent also determined increases in petitioners' income in the amounts of $60,077 and $5,763 for 1990 and 1991, respectively, for gain on the sale of stock in Epoch Management, Inc., which sale petitioners failed to report on their returns. Petitioners have conceded the latter adjustments. Respondent determined accuracy-related penalties for 1990 and 1991, having determined that the underpayments of tax were "due to negligence or intentional disregard of rules and regulations."

Discussion

Inclusion of COD Income in Basis

Petitioners argue that petitioner was correct in increasing the basis in his ECC stock by his share of the COD income. In *Nelson v. Commissioner*, 110 T.C. 114 (1998), we held that COD income realized and excluded from gross income under section 108(a) does not pass through to shareholders of an S corporation as an item of income in accordance with section 1366(a)(1) so as to enable an S corporation shareholder to increase the

basis of his stock under section 1367(a)(1). Petitioners do not distinguish this case from *Nelson v. Commissioner, supra.* They ask us to overrule a recent Court-reviewed opinion, as being decided incorrectly. We decline to do so. Accordingly, we hold that petitioner may not increase the basis in his ECC stock by his share of the COD income.

Accuracy-related Penalties

Section 6662(a) imposes an accuracy-related penalty of 20 percent on any portion of an underpayment of tax that is attributable to items set forth in section 6662(b). Included in those items is negligence or disregard of rules or regulations. Sec. 6662(b)(1). Section 6662(c) provides that for purposes of section 6662, "the term 'negligence' includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard."

The accuracy-related penalty will not be imposed with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion. Sec. 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith depends upon the facts and circumstances. Sec. 1.6664-4(b)(1), Income Tax Regs. The most important factor is the extent of the taxpayer's effort to determine the taxpayer's proper tax liability. *Id.*

Respondent determined that petitioners' underpayments of tax were due to negligence or intentional disregard of rules or regulations. Respondent since has

conceded the portions of the penalties related to the COD issue. The remaining portions of the penalties relate to the income conceded by petitioners; i.e., the gain on the sale of stock in Epoch Management, Inc.

Petitioners argue that they were not negligent, but merely mistaken, in their reporting position with respect to the Epoch Management, Inc. stock. They state in their brief that they concluded they could recover all of their basis before reporting any gain. They also allege that their failure to include the gain was inadvertent, in view of the amounts of the adjustment resulting from this omission ($60,077 and $5,763 for 1990 and 1991, respectively) as compared to the total income reported ($778,781 and $1,215,732, respectively).

Petitioners have supplied us with no evidence with respect to the Epoch Management, Inc., stock transaction or with respect to their decision that the gain on the sale of the stock was not includable in income. Petitioners have the burden of proof on this issue. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933). The fact that this case was submitted fully stipulated does not alter the burden of proof. Rule 122(b); *Alumax Inc. v. Commissioner*, 109 T.C. 133, 160 (1997), affd. __ F.3d __ (11th Cir., Jan. 21, 1999). Petitioners have failed to establish that they were not negligent with respect to the underpayments stemming from the omission of the gain from the sale of the Epoch Management, Inc., stock. Therefore, we hold that they are liable for the portions of the accuracy-related penalties related to that gain.

In keeping with the parties' concessions and our holdings as set forth above,

Decision will be entered under Rule 155.

APPENDIX C

STATUTORY APPENDIX

Internal Revenue Code of 1986 (26 U.S.C.) (1991):

§ 108. Income from discharge of indebtedness

(a) Exclusion from gross income

(1) In general

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent, or

(C) the indebtedness discharged is qualified farm indebtedness.

* * * * *

(3) Insolvency exclusion limited to amount of insolvency.

In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

(b) Reduction of tax attributes

(1) In general

The amount excluded from gross income under paragraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction. Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL

Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit

Any carryover to or from the taxable year of a discharge of an amount for purposes of determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) Capital loss carryovers

Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(D) Basis reduction

(i) In general

The basis of the property of the taxpayer.

(ii) Cross reference

For provisions making the reduction described in clause (i), see section 1017.

(E) Foreign tax credit carryovers

Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

(3) Amount of reduction

(A) In general

Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

(B) Credit carryover reduction

The reductions described in subparagraphs (B) and (E) of paragraph (2) shall be 33 1/3 cents for each dollar excluded by subsection (a).

(4) Ordering rules

(A) Reductions made after determination of tax for year

The reductions described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.

(B) Reductions under subparagraph (A) or (C) of paragraph (2)

The reductions described in subparagraphs (B) and (E) of paragraph (2) (as the case may be) shall be made

first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which such carryover arose.

* * * * *

(5) Election to apply reduction first against depreciable property

(A) In general

The taxpayer may elect to apply any portion of the reduction referred to in paragraph (1) to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.

* * * * *

(d) Meaning of terms; special rules relating to subsections (a), (b) and (g)

* * * * *

(2) **Insolvent**

For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

* * * * *

(6) Subsections (a), (b), and (g) to be applied at partner level

In the case of a partnership, subsections (a), (b), and (g) shall be applied at the partner level.

(7) Special rules for S corporation

(A) Subsections (a), (b), and (g) to be applied at corporate level

In the case of an S corporation, subsections (a), (b), and (g) shall be applied at the corporate level.

(B) Reduction in carryover of disallowed losses and deductions

In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year.

(C) Coordination with basis adjustments under section 1367(b)(2)

For purposes of subsection (e)(6), a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2).

* * * * *

(e) General rules for discharge of indebtedness (including discharges not in Title 11 cases or insolvency)

For purposes of this title

(1) No other insolvency exception.

Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

* * * * *

§ 1366. Pass-thru of items to shareholders

(a) Determination of shareholder's tax liability

(1) In general

In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's—

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

* * * * *

(b) Character passed thru

The character of any item included in a shareholder's prorata share under paragraph (1) of subsection (a) shall be determined as if such item were realized

directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

(c) Gross income of a shareholder

In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

(d) Special rules for losses and deductions

(1) Cannot exceed shareholder's basis in stock and debt

The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraph (1) of section 1367(a) for the taxable year and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) Indefinite carryover of disallowed losses and deductions.

Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

* * * * *

§ 1367. Adjustments to Basis of Stock of Shareholders, etc

(a) General rule

(1) Increases in basis

The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis

The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1) * * * [.]

* * * * *

Supreme Court, U.S.
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No. 00-242

In The

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JAMES H. PUGH, JR. AND ALEXIS PUGH,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

The sole question presented in this case is whether the Eleventh Circuit Court of Appeals correctly determined that Respondent James H. Pugh, Jr., who was a shareholder of an insolvent S corporation, was entitled to increase the basis for federal income tax purposes in his S corporation stock under 26 U.S.C. § 1367(a)(1)(A) for his *pro rata* share of the S corporation's cancellation of indebtedness income which was excluded from gross income of the S corporation under 26 U.S.C. § 108(a)(1)(B).

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STATEMENT OF THE CASE

This case was submitted to the United States Tax Court by Petitioner Commissioner of Interval Revenue ("Commissioner") and Respondents on a fully stipulated basis. Petition, App. 19a. Thus, there are no disputes between Commissioner and Respondents with respect to any material issues of fact.

Respondent James H. Pugh, Jr. ("Taxpayer") owned 97 percent of the outstanding stock of Epoch Capital Corporation ("ECC") during ECC's taxable year ending December 31, 1990.[1] Petition, App. 2a. ECC was an S corporation for federal income tax purposes throughout ECC's taxable year ending December 31, 1990. Petition, App. 2a. ECC realized income from cancellation of indebtedness ("COD income") in 1990 in the amount of $661,357 which ECC excluded from income pursuant to section 108(a)(1)(B) of the Internal Revenue Code of 1986 (as amended), 26 U.S.C. §§ 1-9833 (the "Code") because ECC was insolvent both before and after it was discharged from this debt. *Ibid.* Although Code section 108(b) generally exacts a price for the exclusion granted under Code section 108(a) by causing a taxpayer to reduce certain tax attributes, such as suspended losses, neither ECC nor Taxpayer had any unused or suspended losses as of December 31, 1990. Petition, App. 2a, 10a and 11a. Consequently, ECC had no tax attributes to which the attribute reduction rules of Code section 108(b) could apply.

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[1] References to "Respondent" or "Taxpayer" in the singular are to Respondent James H. Pugh, Jr. Alexis Pugh is party to this proceeding solely by reason of having filed joint federal income tax returns with James H. Pugh, Jr. for the taxable years at issue.

Taxpayer's tax basis in his ECC stock at the beginning of the 1990 taxable year was $694,659. Taxpayer's *pro rata* share of ECC's ordinary losses for the 1990 taxable year was $199,857. Petition, App. 2a. ECC separately stated the excluded COD income as an item of income exempt from taxation under Code section 108 and Taxpayer included his *pro rata* share of such tax-exempt income in the amount of $612,245 on his 1990 federal income tax return. *Ibid.* Taxpayer decreased the tax basis in his ECC common stock in 1990 by $199,857 under Code section 1367(a)(2) to reflect his *pro rata* share of ECC's ordinary losses for 1990. *Ibid.* Taxpayer also increased the tax basis in his ECC common stock in 1990 by the amount of $612,245 under Code section 1367(a)(1)(A), representing his *pro rata* share of the COD income which was excluded from ECC's gross income pursuant to Code section 108. *Ibid.*

ECC was liquidated in 1990 and, because it was insolvent, nothing was distributed to Taxpayer or any of its other shareholders pursuant to the liquidation. Consequently, Taxpayer's ECC stock became worthless in 1990. *Ibid.* Taxpayer reported an ordinary loss on his ECC stock in 1990 in the amount of $100,000 in accordance with Code section 1244, which permits up to $100,000 of losses that would otherwise be treated as capital losses to be claimed as ordinary losses. As a result thereof, Taxpayer's tax basis in his ECC stock was reduced by $100,000. *Ibid.* Taxpayer then claimed a deduction for a worthless security under Code section 165(g) on his 1990 federal income tax return in an amount equal to the remaining tax basis (*i.e.*, after reduction for the $199,857 of current operating losses and the $100,000 reduction under Code section

1244) in his ECC stock. In claiming such deduction, Taxpayer included his full $612,245 distributive share of ECC's COD income in his tax basis for purposes of computing the loss from worthless securities under Code section 165(g). *Ibid.* At issue in this case is whether the portion of the deduction for worthless securities attributable to the increase in basis from COD income is an allowable deduction.

Taxpayer filed a petition in the Tax Court to contest a proposed deficiency based upon Commissioner's disallowance of $612,245 of the deduction claimed by Taxpayer in 1990 for the worthlessness of his ECC stock. Petition, App. 3a. The Tax Court rendered a decision in favor of Commissioner based upon its prior decision in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999).

Taxpayer appealed the decision of the Tax Court to the Eleventh Circuit Court of Appeals. The Eleventh Circuit reversed the decision of the Tax Court and held that Taxpayer's *pro rata* share of COD income was "tax-exempt income" which passed through to Taxpayer under Code section 1366(a)(1)(A) and increased the tax basis in his ECC stock under Code section 1367(a)(1)(A). *Pugh v. Commissioner*, 213 F.3d 1324, 1329-1331 (11th Cir. 2000).

ERRORS IN PETITION FOR A WRIT OF CERTIORARI

The Petition for a Writ of Certiorari (the "Petition") filed by Commissioner in this proceeding describes the

application of Code section 108 to the COD income of an insolvent S corporation thusly:

> Although Section 108 of the Code specifies that discharge of indebtedness is *not* an item of income for an insolvent corporation, respondent argues that it should nevertheless be *treated* as if it were an item of income for purposes of Sections 1366 and 1367 of the Code.

Petition, App. 3a (emphasis in original). Similarly, the Petition also contains the following statement:

> Respondent then treated his *pro rata* share of the debt forgiven to ECC ($612,245) as an item of 'income' passing through to him under Section 1366(a)(1)(A) . . . even though, for the reasons described above, Section 108(a) of the Code expressly states that this is *"not"* an item of income.

Petition, App. 4a (emphasis in original).

The assertion that Code section 108 expressly states that COD income is not an item of income of an insolvent S corporation is incorrect. Although Petitioner would like to read this language into Code section 108, it simply is not there. Section 1366(a) provides in part as follows:

> In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable income of the S corporation ends . . . there shall be taken into account the shareholder's *pro rata* share of the corporation's –
>
> > (A) items of income (*including tax-exempt income*), loss, deduction or credit the separate treatment of which could affect the liability for tax of any shareholder . . .

(emphasis added). Commissioner attempts to expand the scope of Code section 108(a) from merely excluding COD income from gross income to also precluding it from qualifying as an "item" of "tax-exempt income" of an S corporation for purposes of Code sections 1366(a)(1)(A) (quoted above) and 1367(a)(1)(A). Code section 108(a)(1)(B) provides that gross income does not include COD income of an insolvent taxpayer. This is precisely the same operational language that is used in Code sections 101 (excluding life insurance proceeds from gross income), 103 (excluding interest from state and local bonds from gross income) and 111 (excluding amounts received in one taxable year that were deducted in prior taxable years but which produced no tax benefits to the taxpayer), all of which Commissioner acknowledges to be "items of income" that will pass through to an S corporation shareholder under Code section 1366(a)(1)(A) and increase basis under Code section 1367(a)(1)(A).[2]

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[2] In Reg. § 1.1366-1(a)(2)(viii), which became effective on August 18, 1998 but does not apply to the taxable year involved in this proceeding, Commissioner acknowledges that life insurance benefits excluded under section 101 and tax-exempt interest excluded under section 103 constitute "tax-exempt income" and "items of income" that flow through to an S corporation's shareholders under Code section 1366(a)(1)(A). Presumably as a result of its favorable decision in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999), in this new regulation Commissioner adopted a very narrow interpretation of what constitutes "tax-exempt income" that will be eligible to pass-through to an S corporation's shareholders, and specifically provided that COD income excluded under Code section 108 will not pass-through to an S corporation's shareholders. The validity of this regulation's treatment of COD income is certainly open to question in light

Moreover, all of these provisions (including Code section 108) are grouped together in Part III of Subchapter B, Subtitle A of the Code which is entitled "Items Specifically Excluded from Gross Income," and include Code sections 101 through 139. Just as in the case of Code section 108, each of these Code sections provides for a specific exclusion from gross income and employs either identical or substantially similar operative language to that employed in Code section 108 in order to achieve exclusion from gross income. Thus, as the Eleventh Circuit correctly determined, COD income of an S corporation which is excluded under Code section 108(a)(1)(B) must be treated as an "item" of "tax-exempt income" that passes through to its shareholders under Code section 1366(a)(1)(A) and increases the tax basis in their stock under Code section 1367(a)(1)(A) to the same extent as, for example, income excluded under Code sections 101, 103 and 111.

REASONS FOR DENYING THE WRIT

In the Petition, Commissioner argues that a Writ of Certiorari should be granted in this proceeding because "This case presents the same question that is presented in *Gitlitz v. Commissioner* . . . which is set for argument in this Court on October 2, 2000." Although not specifically stated by Commissioner, Commissioner is presumably

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of the holdings of the Third, Sixth, Seventh and Eleventh Circuit Courts of Appeals cited in footnotes 3 and 4, *infra*.

also arguing that there is a split among the circuits with respect to the issue in this case.

The issue presented in this case is *not* identical to the issue before the Court in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), *cert. granted*, No. 99-1295 (May 1, 2000). In *Gitlitz*, the taxpayer had substantial suspended losses that would have been released and made available to the taxpayer by the pass-through of excluded COD income. The Tenth Circuit Court of Appeals held in favor of the Commissioner in *Gitlitz* on the basis that the COD income was completely absorbed under Code section 108(b) by the taxpayer's suspended losses, and, thus, was not available to pass through to the taxpayer. 182 F.3d at 1148. As noted above, the Taxpayer in this case had no suspended losses or other tax attributes which, under the theory of the Tenth Circuit, would otherwise absorb COD income and prevent it from passing through to Taxpayer. Thus, the primary issue addressed in *Gitlitz*, which is also the primary issue that has led to a split in the various circuit courts of appeal that have addressed the COD issue,[3] is not present in this case.

The Third, Sixth, Seventh and Eleventh Circuit Courts of Appeals have all agreed that, to the extent that the COD income of an S corporation is *not* absorbed by suspended losses or other tax attributes, it must be treated as an "item of income" that passes through to a shareholder of an S corporation under Code section

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[3] *See Gaudiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000); *United States v. Farley*, 202 F.3d 198 (3d Cir. 2000); *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000); and *Gitlitz*, *supra*.

1366(a)(1)(A) and thus increases tax basis in such shareholder's stock in the S corporation under Code section 1367(a)(1)(A).[4]

Commissioner argues that the Tenth Circuit Court of Appeals in *Gitlitz* held that COD income that is not absorbed by suspended losses or other tax attributes will, nevertheless, be disregarded and will not pass through to the shareholders of an S corporation. Petition, App. 5a, 6a. As noted above, however, the Tenth Circuit based its decision in favor of Commissioner upon its conclusion that all of the COD income was effectively absorbed by suspended losses. Thus, the question of what treatment would have been accorded any COD income in excess of suspended losses was not a necessary element in rendering its opinion. The Tenth Circuit's opinion in *Gitlitz* tangently addressed this issue in dicta, and its conclusions in this regard are not altogether clear. Consider the following language from the Tenth Circuit's opinion:

> Section 1366(a)(1) makes clear that all items of income are attributed initially to the corporation. *Because the subchapter S corporation is not a tax-paying entity, however, the items must pass through to shareholders unless they are absorbed by tax attribute reductions.*
>
> The outcome of this case is ultimately determined by the timing of the pass-through. If the attribute reduction procedures precede the pass-through, the corporation's excluded discharge

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[4] *Gaudiano*, 216 F.3d at 534, 535; *Pugh v. Commissioner*, 213 F.3d at 1327-1330; *Farley*, 202 F.3d at 209, 210; and *Witzel*, 200 F.3d at 498. *Accord*, *Hogue v. United States*, 2000 WL 2651 (D. Ore. 2000).

> of indebtedness income is absorbed before it can pass through to shareholders and compel basis adjustments. Potential windfalls are thus avoided. *If, on the other hand, attribute reduction takes place after the pass-through, the taxpayer's theory must prevail.* For the reasons described below, we conclude attribute reduction must precede the pass-through.

182 F.3d at 1148 (emphasis added). The above-quoted language clearly states that, in the absence of offsetting tax attributes, the normal S corporation flow-through rules will apply to COD income of an S corporation. The Tenth Circuit also indicated its assumption elsewhere in its opinion that the excluded COD income constitutes "tax-exempt income." 182 F.3d at 1151, n.7.

The ambiguity in the Tenth Circuit's opinion arises from two examples set forth in footnote 6. Examples 1 and 3 of footnote 6 state, without any explanation or citation of authority, that any excluded COD income in excess of available tax attributes "is ignored and has no tax consequences." 182 F.3d at 1150. This result is inconsistent with the express language employed by the Tenth Circuit in its opinion which is quoted above. Moreover, the explanation is merely dicta as *Gitlitz* did not involve any COD income that was not absorbed under the Tenth Circuit's rationale by available tax attributes.

In short, the resolution of this issue did not play any part in the ultimate holding of the Tenth Circuit in *Gitlitz*, and, further, the examples contained in footnote 6 of the opinion, which are devoid of citation of authority or explanation and directly contradict the above-quoted language set forth in the text of its opinion, are merely dicta.

Thus, the Tenth Circuit in *Gitlitz* is not in conflict with the positions of the Third, Sixth, Seventh and Eleventh Circuits solely with respect to the issue of whether excluded COD income of an S corporation which is not otherwise absorbed under Code section 108(b) by suspended losses will pass-through to its shareholders and increase the basis in their stock.[5] Based upon this analysis, there is no meaningful split among the circuits on the issue in this case, and there is, therefore, no basis for granting Commissioner's Request for Certiorari in this proceeding.

CONCLUSION

The Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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[5] Commissioner notes that the Tenth Circuit also affirmed the Tax Court's decision in *Nelson v. Commissioner* (182 F.3d 1152 (10th Cir. 1999)) which, similar to the facts in this proceeding, did not involve any suspended losses. However, the Tenth Circuit's opinion in *Nelson* contained no discussion of the issue but referred only to its prior opinion in *Gitlitz* as the basis for its holding.